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ABSTRACT

An overview of the former taxation of scholarships and fellowships is presented, along with information on the practical implications of the changes brought about by the Tax Reform Act of 1986. Included is a copy of the guidelines issued by the Treasury Department and supplementary legislative history information from the "General Explanation of the Tax Reform Act of 1986," which was prepared by the staff of the Joint Committee on Taxation. The Tax Reform Act of 1986 substantially revised Section 117 of the Internal Revenue Code, which defines when funds received in the form of a scholarship or fellowship award are excludable from income. The changes include: (1) only degree candidates may exclude any portion of a scholarship or fellowship from income; (2) degree candidates may only exclude the amount of scholarship and fellowship awards up to the aggregate of tuition and required fees, books, and equipment; and (3) the portion of any scholarship or fellowship that is attributable to services performed by the student (including teaching or research) is subject to taxation as compensation, even if such services were requirements for the degree. Where appropriate, reference is made to the extensive legal guidelines that existed under prior law. (SW)

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June 1987 Number 23

SCHOLARSHIPS AND FELLOWSHIPS
The Tax Reform Act of 1986

by Sandra H. McMullan
Executive Director for Tax Policy and General Counsel
The National Association of Independent Colleges and Universities

Includes **Treasury Guidelines**
and excerpts from **General Explanation of the Tax Reform Act of 1986**

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SPECIAL REPORT

HE 020 591

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June 1987

Dear NASFAA Member:

As you know, the Tax Reform Act of 1986 (P.L.99-514) made certain changes to the treatment of scholarships and fellowships, including those awarded on the basis of financial need. This **Special Report** contains a paper on the taxation of scholarships and fellowships. The paper was written by Sandra H. McMullan, Executive Director for Tax Policy and General Counsel for the National Association of Independent Colleges and Universities (NAICU).

This paper will provide you with the available interpretative information on this topic. Also included is a copy of the guidelines issued by the Treasury and supplementary legislative history information from the General Explanation of the Tax Reform Act of 1986, prepared by the staff of the Joint Committee on Taxation.

As additional information becomes available on this important issue, we will share it with you.

Sincerely,

Dallas

Dallas Martin
Executive Director

SCHOLARSHIPS AND FELLOWSHIPS
The Tax Reform Act of 1986

Sandra H. McMullan
Executive Director for Tax Policy and General Counsel
The National Association of Independent Colleges and Universities
June 15, 1987

The Tax Reform Act of 1986[1] substantially revised Section 117 of the Internal Revenue Code, which defines when funds received in the form of a scholarship or fellowship award are excludable from income. The Act made three fundamental revisions to the substance of former Section 117:

1. Only candidates for a degree may exclude any portion of a scholarship or fellowship from income. All nondegree students, including post-doctoral fellows or students studying outside the degree process, are taxable on the full amount of any scholarship or fellowship received.

2. Degree candidates may only exclude the amount of scholarship and fellowship awards up to the aggregate of tuition and required fees, books and equipment. Awards in excess of this amount -- most notably funds for room and board or living expenses -- are now subject to federal income tax.

3. The portion of any scholarship or fellowship that is attributable to services performed by the student (including teaching or research) is subject to taxation as compensation, even if such services were requirements for the degree.

Until mid-April, when the IRS issued interpretive guidelines for some of the issues,[2] few campuses had revised their scholarship awards to conform to the Act because of the lack of clarity over even such basic issues as withholding and reporting obligations. While many questions remain unresolved, these guidelines do clarify that campuses are not required to report all grants to the IRS, and that only awards granted to foreign students or in lieu of compensation are subject to withholding. The need to make new academic year awards and to provide students with information about the likely tax treatment of these funds[3] are prompting campuses to address these changes.

This paper provides a brief overview of the former tax treatment accorded to scholarships and fellowships, and summarizes the practical implications of the changes brought about by the Tax Reform Act. This analysis relies upon the Treasury's [preliminary] guidelines (attached), and the legislative history of the Tax Reform Act (attached). Where appropriate, reference is made to the extensive legal guidelines which existed under prior law. Campuses are reminded to utilize counsel for assistance with any revisions, specifically with reference to timing and the application of the relevant facts to this new complex law.

I. Background on Section 117

Prior to the Tax Reform Act, a scholarship or fellowship[4] received by a degree candidate[5] was fully excluded in calculating the taxpaper's taxable income. Nondegree candidates were eligible to exclude up to $300 per month for up to 36 months of scholarship or fellowship support.[6]

By definition, an award provided as compensation or which contained a requirement of future service from a recipient was not excludable.[7] The academic practice of engaging students in activities which would be considered employment in a different context (such as teaching or research in their field of study) brought many scholarship recipients into conflict with the IRS; this

was so in spite of a specific exemption for students providing services which were required of all candidates for the degree.[8] This controversy became more marked after the IRS ruled that awards which mandated future service were taxable.[9]

Congress specifically addressed this legislatively, first seeking to make these awards nontaxable on a temporary basis.[10] Two permanent amendments were made to the Tax Code. In the first, Congress permitted recipients to exclude federally-funded awards which would otherwise become taxable solely because of future service.[11] In the second, Congress permitted the exclusion of "tuition remission" or tuition grants to graduate teaching and research assistants.[12]

This history was, to a significant degree, reversed in the Act. The substance of the revision of Section 117 was first proposed by the Administration in the first of its tax reform proposals. It was adopted unchanged in the House, rejected in the Senate, but reinstated with only minor revisions in the Conference on the bill.

II. Effective Dates for Changes

The statutory effective date of these changes is August 16, 1986;[13] however the Conference Report created grandfathering rules which potentially insulated most of the 1986-87 academic year awards.[14] These rules are not clear or precise, and will be frustrating for campuses because they place substantial meaning in previously insignificant, nonacademic practices, such as whether written or oral communications were used to communicate the award, on which day the communication was given, and even the due date for the payment of tuition.

Two categories of recipients are particularly difficult to cover under these grandfathering provisions. First are students who were not notified of aid awards before August 16, 1986. It is clear that students who have an award letter with a postmark or internal date prior to August 16, 1986 are not subject to the new law.[15] The status of students who received oral confirmation of an award by that date is less clear; the Treasury guidelines do not cover them, but they may nonetheless have a solid legal argument based on the existence of binding legal contracts. Second are those students who were granted awards between August 16, 1986, and January 1, 1987, but failed to expend those funds prior to January 1, 1987.[16]

The Treasury has confirmed that it considers awards to be grandfathered beyond this academic year if the original award communication was made before August 16, 1986, and contained a commitment to continue support for a longer period of time.[17] The IRS indicated that it considers awards to be eligible for grandfathering into a later academic period even if need or academic success must be demonstrated to continue to award. Increases in awards above those projected in the original award communication are taxable; however, the base amount would continue to be untaxed.[18]

The effect of these rules is significant, particularly for graduate student awards which might otherwise be subject to immediate taxation as well as possible withholding of awarded amounts. Careful attention should be paid to the actual letters of commitment to an award or to institutional practice of committing funds to students with these new rules in mind.

III. Degree Students Only

The Act restricted the exclusion of income received in the form of scholarships and fellowships to only those taxpayers who are degree candidates.

One category of students who must cope with these changes are those post-doctoral students who have received awards which qualified for the nondegree candidate limited exclusion. Under previous law, the IRS required some post-doctoral fellowships to be treated as wages, rather than scholarships. Campuses which treated some post-doctoral awards as an excludable fellowship will

now need to determine whether these are taxable compensation or a taxable scholarship or fellowship.[19]

Similar issues arise with respect to students enrolled in a program which does not tender a degree, either because it is an experimental program or because the student has elected to take courses outside of the degree process.

In both cases, unless these awards otherwise constitute compensation, the Act does not convert these nondegree candidate scholarships or fellowships into funds on which the institution must institute withholding;[20] the tax law requires only that these scholarships or fellowships become subject to personal income tax. These funds, which were not previously considered wages, are not likely to require changes in administrative practices on the campuses. Because they are not subject to withholding, campuses will, however, need to inform nondegree recipients of the changed status of the award.

IV. Exclusion Limited to Tuition

The Act places a new limitation on the portion of the scholarship or fellowship which is excludable from income.[21] Unlike the previous tax law, which did not set any maximum on allowable exclusions for other than nondegree students, the new Code sets an upward limit of tuition and required books, fees, and equipment on the amount a taxpayer may exclude. Awards which are specifically restricted to expenses other than tuition and required expenses may not be excluded by a student.[22] The Act does not impose a requirement that a student trace the scholarship or fellowship fund through particular expenditures; it instead permits the student to aggregate tuition and excludable expenses and to offset, dollar for dollar, the sum of all scholarship and fellowship awards.

This change affects both undergraduate and graduate students, albeit to a different degree. Undergraduates do not typically receive grants in excess of tuition, nor are their typical annual earnings in excess of the new standard deduction and personal exclusion, which, combined, leaves an untaxed $4,950 per taxpayer in 1988.[23] Thus most undergraduates will not experience an actual change in their tax liability. However, among those who will experience an increased tax liability are students whose need and merit result in either a single large grant or multiple grants. These students would typically work in the summer (and possibly part-time during the year) and, hence, may well earn more than the baseline of $4,950 above which taxes would be applied.[24] Students whose income base increases by virtue of scholarships may find themselves required to make estimated tax payments as well.

The most significant increase in tax liability will be experienced by the many graduate students who receive a stipend above tuition to meet living expenses. Like scholarships granted to undergraduates, the scholarship for a graduate student in excess of tuition will be subject to taxation. Stipends which are given for living expenses will usually be taxed. This same category of students would also typically be engaged in teaching or research activities; if the institution does not reimburse for such services separately, part of their stipend or tuition grant will likely be considered to be taxable income, hence, subject to withholding responsibilities.[25] If the institution does not segregate a compensation amount from the scholarship, the whole of the award may become taxable to the recipient.

Undergraduates and graduate students may also calculate amounts spent for required books, fees, and equipment, and exclude the corresponding amount of scholarship or fellowship funds from income. The IRS has not specifically addressed what expenditures are covered, or how these amounts may be proven. It is safest to assume that the IRS will require, as it did under its regulations implementing a similar provision in previous law,[26] that actual expenditures be documented in the taxpayer's files through receipts. It is possible that the IRS may be more

generous and permit students to exclude a flat amount used by the campus in projecting student budgets.

Amounts received above tuition and required expenses, which are now taxable, are not subject to any reporting by the college or other grantor.[27] The law places upon the student the obligation to determine the taxable amount, by offsetting tuition and allowable expenses against the total of all grants received (including federal Pell Grants, Supplemental Educational Opportunity Grants, National Science Foundation and other federally-funded graduate fellowships and trainership programs, as well as the institutional funds given to them.) Loans, including the subsidized portion of federal loans, are not considered scholarships or fellowships; like other types of borrowed funds, these dollars are not considered income for federal tax purposes.

V. Graduate Teaching or Research Services

Among the most difficult of the changes made by the Act is the imposition of a wage-type tax upon any portion of a scholarship or fellowship which is attributable to otherwise uncompensated services[28] performed by the scholarship recipient. The Act eliminated language which permitted graduate students performing teaching or research activities as part of a degree requirement to exclude the full amount of that scholarship or fellowship.[29] It also elimininated the exclusion for federal employees and recipients of federal grants which required future service. Finally, although the Act extended the tuition remission exclusion for graduate teaching/research assistants,[30] these funds may be treated as taxable compensation if services provided are not otherwise compensated.[31]

This represents a dramatic change for the many campuses which do not pay cash for services performed by scholarship recipients,[32] particularly for the academically required teaching and research services. Commencing with the 1987-88 academic year,[33] campuses which have no experience calculating the value of services performed by students must quantify reasonable compensation,[34] separating the compensatory and noncompensatory portions of a scholarship award,[35] and commencing withholding on the former.[36]

This set of changes poses serious issues of interpretation and application for campuses because, unlike the other changes discussed thus far, it requires the campuses to begin reporting and withholding. It also recharacterizes the funds given to the student from that of student aid to that of compensation, thus potentially triggering some state employment laws, and eliminating the traditional view of these activities as part of the education process.

One of the most significant of these spillover effects arises in the context of reimbursements under federal research grants. Currently, campuses may recover, as part of the reimbursements for federal research, compensation paid to graduate students, even if paid in the form of a tuition grant.[37] Campuses which characterized the tuition grants as "compensation" did not previously complicate the students' ability to treat those funds as nontaxable because of the statutory exemption created for those grants. Although the requirements of the federal research allocation rules have not changed, the effect of this characterization on students who are seeking to have these considered to be noncompensatory poses difficult issues for some campuses.

One potential solution would be to create an Employee Educational Assistance plan for graduate students. The employee educational assistance plans permit the college or university to provide tax-free educational benefits (up to $5,250 per year) to its employees, including its graduate teaching and research assistants. Under this authority, tuition remission is characterized as compensation and remains tax-free.[38] The creation of an employee educational assistance plan would be helpful for many students who receive a tuition grant from the college or university; it does not help the many graduate students who receive a federal or other form of noncampus fellowship, such as a National Research Service Award, which has a service requirement in the future. Such awards, by these changes, would become taxable to the extent they exceed tuition

and required educational expenses. Also, campuses which award in excess of the $5,250 permitted under the section will find the solution less satisfactory than those with awards which fall under this cap.

VI. Conclusion

This set of changes is far-reaching in its implications for campuses and students. Care needs to be taken to make a good faith effort to comply with these revisions and to communicate helpful information to assist students in their new tax reporting and calculations. Campuses should take seriously the IRS request to inform students of these changes, because failure by students to report and pay tax on this income source could well result in increased reporting responsibilities and tax liabilities for campuses and students alike.

ENDNOTES

1. P.L. 3838, enacted into law September 22, 1986 (hereinafter referred to as The Act.)

2. Internal Revenue Service Advance Notice No. 87-31 (April 13, 1987) (Attached). This advance notice is not the same as regulations, which are binding and represent the Department's official interpretations, and once issued may only be revised through the regulatory process. Guidelines articulate a more limited policy position. In general, policies adopted which were specifically guided in the policy directive are safe from retroactive invalidation.

3. IRS Advance Notice 87-31 "recommended that the grantor formally advise the recipient in writing that amounts granted after August 16, 1986, for expenses incurred on or after January 1, 1987, are taxable income, if the aggregate scholarship or fellowship amounts received by the recipient exceed tuition and fees (not including room and board) required for enrollment or attendance at the educational institution and fees, books, supplies, and equipment required for courses of instruction."

4. A scholarship or fellowship was defined as "an amount paid or allowed to or for the benefit of a student, whether graduate or undergraduate, to aid such student in pursuing studies", and included room, board, and such related expenses as travel to and from school. Treas. Regs. 1.117-(3)(a). The U.S. Supreme Court upheld this definition (Bingler v. Johnson, 394 U.S. 741 (1969)), with an oft-repeated and shorter definition of a "relatively disinterested, 'no-strings' educational grant, with no requirement of any substantial quid pro from the recipient."

5. The term "candidate" for a degree meant, at the postsecondary level, "an undergraduate or graduate student at a college or university who was pursuing studies or conducting research to meet the requirements for an academic or professional degree." Treas. Regs. 1.117(3)(e)(1).

6. Former Section 117(b)(2). Scholarship and fellowship recipients who were not candidates for a degree could exclude a life-time maximum of $10,800. Only awards granted by an educational institution (or other 501(c)(3) organizations, a foreign government, or federal, state, or local government agency) were excludable. The dollar limitation was not applicable to funds granted for travel, research, clerical help, or equipment.

7. Former-law Section 117(b)(1) provided that the exclusion was not applicable "to that portion of any amount received which represents payment for teaching, research, or other services in the nature of part-time employment required as a condition to receiving the scholarship or fellowship."

See also Treas. Regs. 1.117 - (3)(a); Bingler v. Johnson, 394 U.S. 741 (1969).

8. Section 117(b).

9. See, e.g., Rev. Rulings 77-319, 1977-2, C.B. 48, (National Research Services Awards which requires the recipient to provide research or teaching in their field of study for a period equal to the grant period.)

10. National Research Service Awards (NRSA's) were treated as an excludable scholarship and fellowship from 1978 through 1981 under Section 161 of the Revenue Act of 1978. P.L. 96-541 amended Section 117(c) to permit the exclusion of grants for tuition and related expenses which would otherwise be taxable because of the requirement of future service as a federal employee. Prior to that in 1974, P.L. 93-483 (as amended by P.L. 95-171, P.L. 95-600 and P.L. 96-167) granted a specific exclusion under code Section 117 for payments received by a member of the uniformed services from the federal government for tuition and other educational expenses, paid under the Armed Services Health Professions Scholarship Program or a substantially similar program.

11. P.L. 96-541 amended Section 117(c) to permit the exclusion of grants for tuition and related expenses which would otherwise be taxable because of the requirement of future service as a federal employee.

12. In 1984, Congress amended former Section 117(d), which authorized tuition remission for education below the graduate level for dependents of employees, to permit tuition remission for graduate student teaching and research assistants. P.L. 98-369 adding Section 127(c)(8) amending former Section 117(d). The exclusion applied from January 1, 1984, until December 31, 1985. This section was extended retroactively through the Tax Reform Act, from January 1, 1986 through December 31, 1987.

13. Section 151(d) of the Act.

14. Statement of Managers, H. Rep. No. 99-841, Sept. 19, 1986, Vol. II, P. 17 (hereinafter Conf. Rep. II-____); IRS Notice 87-31.

15. IRS Notice 87-31.

16. IRS Notice 87-31.

17. The Treasury Department took this same view in its original description of the changes it requested in Section 117, considering those commitments to be legally binding on the institution.

18. IRS Notice 87-31.

19. At issue here is whether the post-doctoral candidate's fellowship is an employee or a consultant, issues which are generally determined under state law. These issues were not addressed in the Tax Reform Act.

20. No withholding obligation is imposed upon nonwage funds distributed (IRS Section 3101), and the Treasury Department has indicated that it does not consider scholarships or fellowships to fall within the 1099 miscellaneous income report (Section 3402(a)) requirement. Advance Notice 87-31. Funds distributed to nonresident alien students are subject to special requirements for withholding. Section 123(b)(2). The introduced version of the Technical Corrections Act (H.R. 2636) would subject nonresident aliens receiving scholarships to a 14 percent withholding rate.

21. Section 117(a).

22. Conf. Rep. II-17.

23. Sections 63(c)(2)(c) and 151(f)(1) and (3). This, however, assumes that the taxpayer may claim the full standard deduction and personal exemption amounts. In fact, however, students who are eligible to be considered to be dependent (Section 152(a)) may not claim the personal exemption, and they may only claim the standard deduction if they have earned income (which includes income from scholarships and fellowships for that purpose.) Section 151 (f)(1) and (3).

24. Married students with a working spouse will have an increased baseline, but also an increased income base.

25. Advance Notice 87-31.

26. See Treasury Regulations 1.117-5(d).

27. Advance Notice 87-31.

28. Section 117(a) and (c) of the Act.

29. Conf. Rep. II-17.

30. This authority was created in Section 127(c)(8), which amends Section 117(d). The Act extended Section 127(c)(8) through December 31, 1987, without substantive amendment. However it has been read in conjunction with the changes made in the Tax Reform Act to subject tuition remission to the new 117(c) requirement that service connected awards be subject to taxation as a form of compensation.

31. This issue was not directly addressed by the members of the Senate Finance or House Ways and Means Committees during consideration of the Act, but results from an interpretation of the new Section 117(c) as a condition precedent to Section 127(c)(8). Efforts continue to secure a technical correction on this issue.

32. This only affects recipients of scholarship or fellowship awards, and does not affect the exclusion for students who receive room and board in exchange for serving as a resident assistant. The latter, which is exempt under the "convenience of the employer" exception (Section 119), was not affected by the Act.

33. Many campuses have taken the view that teaching and research positions were part of the scholarship and fellowship package this past year if the original notification of the award occurred before August 16, 1986, and clearly identified a teaching or research position as part of the aid package. Some campuses are reluctant to extend this conclusion because of the possibility that positions may not be available for each student. The specifics of a campus' practice must be carefully reviewed.

34. The Statement of Managers used this term to explain the responsibility for those scholarship recipients whose award is in part compensation. Reasonable compensation is a factually based term, which recurs in other sections of the tax and labor codes. The IRS Notice indicates that campuses must make a "good faith" allocation between compensation and scholarship funds. The Treasury indicated that it considers relevant: 1) the amount of pay given to nonscholarship students; 2) the amount paid to full- and part-time employees with similar responsibilities; 3) and the amount paid by other campuses for the same services. Advance Notice 87-31.

35. There was previously some question about the legality of separating a scholarship into a compensatory and noncompensatory portion, and the withholding of funds from the former and not the latter. The IRS confirmed that this practice is proper. Advance Notice 87-31.

36. It is crucial to remember that only the compensation portions of a scholarship are subject to any withholding or reporting requirements by the grantor. Advance Notice 87-31. Scholarships which are taxable because they exceed the tuition and fees amount or because they are awarded to nondegree students are nonetheless exempt from withholding or even a 1099 miscellaneous income report by the grantor. Some campuses have indicated that they will, at the request of a student, issue a 1099 and are considering making available an optional withholding arrangement. The majority of campuses appear, at this point, to be planning to provide some information on the new laws and limited statements which can be construed as tax advice.

37. Office of Management and Budget Circular A-21 (J-36).

38. Section 127(g). Educational assistance means the payment by the employer of education expenses incurred by an employee, including tuition, fees, books, supplies, and equipment.

Amendments to Section 117, Relating to the Exclusion of Scholarships From Gross Income

Notice 87–31

Background

Section 123 of the Tax Reform Act of 1986 (Pub. L. 99–514) (the Act) amended section 117 of the Internal Revenue Code (the Code), relating to the exclusion of scholarship and fellowship grants from gross income.

Section 117(a) of the Code, as amended by the Act, provides that gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in section 170(b)(1)(A)(ii). Section 117(b), as amended by the Act, provides that a "qualified scholarship" is any amount received by an individual as a scholarship or fellowship grant to the extent that the individual establishes that the amounts received are used for qualified tuition and related expenses. Section 117(b)(2), as amended by the Act, provides that "qualified tuition and related expenses" are tuition and fees required for enrollment or attendance at the educational organization and fees, books, supplies and equipment required for courses of instruction. Thus, scholarship and fellowship grants that are used for other expenses, such as room and board, are not excludable from gross income. Additionally, section 117(c), as amended by the Act, provides that gross income *includes* any portion of amounts received as a scholarship or fellowship grant representing payment for teaching, research or other services required as a condition for receiving the qualified scholarship.

In addition, section 63(c)(5) of the Code, as amended by the Act, permits a child eligible to be claimed as a dependent under section 151(c) on the return of his or her parents to use the standard deduction to offset the greater of $500 or earned income. For purposes of section 63(c), any amount of a scholarship of fellowship grant received by a dependent child that is includible in gross income under section 117 constitutes earned income.

The amendments to section 117 of the Code are applicable to taxable years beginning after December 31, 1986, but only in the case of scholarships and fellowships granted after August 16, 1986. A scholarship or fellowship granted after August 16, 1986, and before January 1, 1987, is governed by section 117 prior to amendment by the Act to the extent that it is received before January 1, 1987, and is attributable to expenses incurred before January 1, 1987. In addition, except as provided below, all scholarships and fellowships granted before August 17, 1986, are excludable from gross income to the extent permitted under section 117 prior to its amendment.

When is a scholarship or fellowship granted

For purposes of the effective date rules relating to section 117 of the Code, as amended by the Act, a scholarship or fellowship is granted when the grantor of the scholarship or fellowship grant either notifies the recipient of the award or notifies an organization or institution acting on the behalf of a specified recipient of the award to be provided to such recipient. If the notification is sent by mail, notification occurs as .he date the notice is postmarked. If evidence of a postmark does not exist, the date of the award letter shall be treated as the notification date.

Scholarships or fellowships granted before August 17, 1986

For purposes of the effective date rules relating to section 117 of the Code, a scholarship or fellowship will be considered granted before August 17, 1986, to the extent that, in a notice of award made before that date, the grantor made a firm commitment to provide the recipient with a fixed cash amount or a readily determinable amount. If a scholarship or fellowship was granted for a period exceeding one academic period (*e.g.*, semester), amounts received in subsequent academic periods will be treated as granted before August 17, 1986, only if (1) the amount awarded for the first academic period is described in the original notice of award as a fixed cash amount or readily determinable amount, (2) the original notice of award contains a firm commitment by the grantor to provide the scholarship or fellowship amount for more than one academic period, and (3) the recipient is not required to reapply to the grantor in order to receive the scholarship or fellowship grant in future academic periods. A requirement that the recipient file a financial statement on an annual basis to show continuing financial need will not be treated as a requirement to reapply to the grantor.

If a scholarship or fellowship satisfying the requirements of the preceding paragraph does not describe the amount to be received in subsequent academic periods as either a fixed cash amount or readily determinable amount, it is presumed that the amount granted before August 17, 1986, to be received in each subsequent academic period is equal to the amount granted for the initial academic period. To the extent that any amount received in a subsequent academic period exceeds the amount received in the initial academic period, the excess amount is treated as a scholarship or fellowship granted after August 16, 1986.

Example 1. On May 1, 1986, A is notified of a scholarship made in the amount of $4000 annually for four years. The total amount of the scholarship is a fixed cash amount. Thus, the total amount of the scholarship for all four years is subject to section 117 of the Code, prior to its amendment by the Act.

Example 2. On May 1, 1986, B is notified of a scholarship that will pay for B's tuition, room, and board for four years. The total amount of the scholarship is readily determinable. Thus, the total amount of the scholarship for all four years is subject to section 117 of the Code, prior to its amendment.

Example 3. On May 1, 1986, C is notified that she is the recipient of a scholarship to attend University X. The notice provides that University X will provide scholarship funds for four years, and specifies that C will receive $5000 during the first year. C is not required to reapply in order to receive scholarship funds during years 2 through 4. However, the notice does not specify the scholarship funds to be received in years 2 through 4. The $5000 received in year 1 is treated as granted before August 17, 1986, because this amount is a fixed cash amount described in the notice of award. In addition, because University X has made a specific commitment to provide scholarship funds during years 2 through 4 without requiring C to reapply for the scholarship, an amount equal to $5000 per year is treated as granted before August 17, 1986 during years 2

through 4. Thus, if C receives $4000 in year 2, the entire amount is treated as granted before August 17, 1986. If, in year 3, C receives $6000, only $5000 of the amount received is treated as granted before August 17, 1986. The additional $1000 received in year 3 is treated as granted after August 16, 1986.

Expenditures incurred before January 1, 1987

In the case of scholarships and fellowships granted after August 16, 1986, amounts received before January 1, 1987, that were attributable to expenditures incurred prior to January 1, 1987, are subject to the rules of section 117 of the Code prior to its amendment. For purposes of this rule, an expenditure is treated as incurred when it becomes properly due and payable by the scholarship or fellowship recipient. However, expenditures relating to an academic period beginning after December 31, 1986, that were prepaid (before billing) by the recipient before January 1, 1987, are not treated as incurred before January 1, 1987. Thus, if in December 1986, an educational organization billed a scholarship recipient for expenses relating to the semester beginning in January 1987, and the recipient used scholarship amounts received prior to January 1, 1987, to pay the expenses on January 5, 1987, the scholarship amounts used to pay such expenses are considered attributable to expenditures incurred prior to January 1, 1987. If, however, on December 31, 1986, a scholarship recipient used scholarship amounts to prepay expenses relating to the academic period beginning January 1987 before the recipient was billed for such expenses, the amounts used are not treated as attributable to expenditures incurred before December 31, 1986.

Reporting and withholding requirements

In General

The Internal Revenue Service intends to promulgate regulations that will provide that unless a scholarship or fellowship grant is subject to the provisions of section 117(c) of the Code, neither the grantor nor the educational organization attended by the recipient (in the case where the educational organization is not the grantor) is required under section 6041 to file a return of information with respect to such grant.

In addition, unless section 117(c) of the Code applies, the amount of a scholarship or fellowship grant is not considered wages. Thus, such amount is not subject to section 3402 (relating to withholding for income taxes), section 3102 (relating to withholding under the Federal Insurance Contribution Act (FICA)), or section 3301 (relating to the Federal Unemployment Tax Act (FUTA)).

Scholarship or fellowship grants subject to section 117(c)

A scholarship or fellowship grant that is includible in gross income under section 117(c) of the Code is considered wages for purposes of section 3401(a). However, the application of FICA or FUTA depends on the nature of the employment and the status of the organization. In addition, the grantor is subject to the provisions of section 6051 (relating to reporting of wages of employees), and is required to file Form W–2 with respect to amounts provided as a scholarship or fellowship grant that are subject to the provisions of section 117(c). For example, if a college reduces a student's tuition solely in return for performing services as a graduate assistant that are required as a condition to receiving the scholarship, the college must file Form W–2 reflecting the amount of the reduction.

Where a portion of a scholarship is granted in return for services described in section 117(c) of the Code, the grantor must make a good faith allocation, based on all the facts and circumstances, to determine that portion of the amount that represents compensation for services provided by the recipient. Factors taken into account in making the allocation include, but are not limited to: (1) compensation paid by the grantor for similar services performed by students with similar qualifications to the scholarship recipient, but who do not receive scholarship or fellowship grants; (2) compensation paid by the grantor for similar services performed by full- or part-time employees of the grantor who are not students; and (3) compensation paid by educational organizations, other than the grantor of the scholarship or fellowship grant, for similar services performed either by students or other employees. Only those amounts allocated to compensation for services provided by the recipient are subject to the reporting and withholding requirements described in this paragraph.

Recipient Obligations

The recipient to the scholarship or fellowship grant is responsible for determining whether the scholarship, in whole or part, is includible in gross income under section 117. In other words, the recipient is responsible for determining whether such grant was used for qualified tuition and related expenses. However, to assist students in understanding their federal tax liabilities, it is recommended that the grantor formally advise the recipient in writing that amounts granted after August 16, 1986 for expenses incurred on or after January 1, 1987, are taxable income, if the aggregate scholarship or fellowship amounts received by the recipient exceed tuition and fees (not including room and board) required for enrollment or attendance at the educational institution and fees, books, supplies, and equipment required for courses of instruction.

Coordination of section 117 of the Code, as amended by the Act, with sections 4941(d)(2)(G)(ii) and 4945(g)(1)

Sections 4941(d)(2)(G)(ii) and 4945 (g)(1) of the Code both refer to scholarship or fellowship grants "subject to the provisions of section 117(a)." There is no indication in the legislative history of section 123 of the Act that Congress intended to limit foundation grants to amounts excludable under section 117, as amended by the Act.

Pending clarification by Congress, the Service will interpret sections 4941(d)(2)(G)(ii) and 4945(g)(i) of the Code as if section 117 had not been amended. Generally, this means that scholarship or fellowship grants will not be treated as self-dealing acts under section 4941 or as taxable expenditures under section 4945 merely because they cover expenses for room, board, travel, research, clerical help, or equipment.

Private foundations that have outstanding rulings that scholarship or fellowship grants are neither self-dealing acts under section 4941 of the Code nor taxable expenditures under section 4945 can continue to rely on these rulings until the Service issues notice to the contrary. Such rulings, however, cannot be relied upon to the extent that such rulings indicate that the grants in question are excludable from recipients' gross income under section 117.

The collection of information requirements in this notice have been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 and has been approved by OMB.

3. Scholarships and fellowships (sec. 123 of the Act and sec. 117 of the Code) [19]

Prior Law

In general

Prior law generally provided an unlimited exclusion from gross income for (1) amounts received by a degree candidate as a scholarship at an educational institution (described in sec. 170(b)(1)(A)(ii)), or as a fellowship grant, and (2) incidental amounts received by such individual and spent for travel, research, clerical help, or equipment (sec. 117). The term scholarship meant an amount paid or allowed to, or for the benefit of, a student to aid in pursuing studies; similarly, a fellowship grant was defined as an amount paid or allowed to, or for the benefit of, an individual to aid in pursuing studies or research (Treas. Reg. sec. 1.117-3).

In the case of an individual who was not a candidate for a degree, the prior-law exclusion was available only if the grantor of the scholarship or fellowship was an educational institution or other tax-exempt organization described in section 501(c)(3), a foreign government, certain international organizations, or a Federal, State, or local government agency. The prior-law exclusion for a nondegree candidate in any one year could not exceed $300 times the number of months in the year for which the recipient received scholarship or fellowship grant amounts, and no further exclusion was allowed after the nondegree candidate had claimed exclusions for a total of 36 months (i.e., a maximum lifetime exclusion of $10,800). However, this dollar limitation did not apply to that portion of the scholarship or fellowship received by the nondegree candidate for travel, research, clerical help, or equipment.

Under prior and present law, an educational institution is described in section 170(b)(1)(A)(ii) if it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. This definition encompasses primary and secondary schools, colleges and universities, and technical schools, mechanical schools, and similar institutions, but does not include noneducational institutions, on-the-job training, correspondence schools, and so forth (Treas. Reg. secs. 1.117-3(b); 1.151-3(c)). Under prior law, the term candidate for a degree was defined as (1) an undergraduate or graduate student at a college or university who was pursuing studies or conducting research to meet the requirements for an academic or professional degree and (2) a student who received a scholarship for study at a secondary school or other educational institution (Treas. Reg. sec. 1.117-3(e)).

[19] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 123; H.Rep. 99-426, pp. 99-103; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 14-17 (Conference Report).

Payments for services

Under prior and present law, amounts paid to an individual to enable him or her to pursue studies or research are not excludable from income if they represent compensation for past, present, or future services, or if the studies or research are primarily for the benefit of the grantor or are under the direction or supervision of the grantor (Treas. Reg. sec. 1.117-4(c)). These regulations have been upheld by the U.S. Supreme Court, which described excludable grants as "relatively disinterested, 'no-strings' educational grants, with no requirement of any substantial quid pro quo from the recipients" (*Bingler* v. *Johnson*, 394 U.S. 741 (1969)).

In the case of degree candidates, prior law also specifically provided that the exclusion did not apply to any portion of an otherwise qualifying scholarship or fellowship grant that represented payment for teaching, research, or other services in the nature of part-time employment required as a condition of receiving the scholarship or fellowship grant (prior-law sec. 117(b)(1)). However, an exception under prior law provided that such services would not be treated as employment for this purpose if all degree candidates had to perform such services; in that case, the recipient could exclude the portion of the scholarship or fellowship grant representing compensation for such services.

Under another prior-law exception, amounts received by an individual as a grant under a Federal program that would be excludable from gross income as a scholarship or fellowship grant, but for the fact that the recipient must perform future services as a Federal employee, were not includible in gross income if the individual established that the amount was used for qualified tuition and related expenses (prior-law sec. 117(c)).

Tuition reduction plans

Section 117(d) provides that a reduction in tuition provided to an employee of an educational institution is excluded from gross income if (1) the tuition is for education below the graduate level provided by the employer or by another educational institution; (2) the education is provided to a current or retired employee, a spouse or dependent child of either, or to a widow(er) or dependent children of a deceased employee; and (3) certain nondiscrimination requirements are met. P.L. 98-611 provided that, for taxable years beginning after December 31, 1983 and ending on or before December 31, 1985, the section 117(d) exclusion also applied to qualified tuition reduction for graduate-level education provided by an educational institution to a graduate student who was employed by that institution in teaching or research activities (Code sec. 127(c)(8)).

Reasons for Change

By extending the exclusion for scholarships or fellowship grants to cover amounts used by degree candidates for regular living expenses (such as meals and lodging), prior law provided a tax benefit not directly related to educational activities. By contrast, students

who are not scholarship recipients must pay for such expenses out of after-tax dollars, just as individuals who are not students must pay for their food and housing costs out of wages or other earnings that are includible in income. The Congress concluded that the exclusion for scholarships should be targeted specifically for the purpose of educational benefits, and should not encompass other items that would otherwise constitute nondeductible personal expenses. The Congress also determined that, in the case of grants to nondegree candidates for travel, research, etc., that would be deductible as ordinary and necessary business expenses, an exclusion for such expenses is not needed, and that an exclusion is not appropriate if the expenses would not be deductible.

In addition, under the Act, the Congress has increased the tax threshold, i.e., the income level at which individuals become subject to tax. Thus, the receipt of a nonexcludable scholarship amount by a student without other significant income will not result in tax liability so long as the individual's total income does not exceed the personal exemption (if available) and either the increased standard deduction under the Act or the taxpayer's itemized deductions. Under the Act, any nonexcludable amount of a scholarship or fellowship grant is treated as earned income, so that such amount can be offset by the recipient's standard deduction even if the recipient can be claimed as a dependent on his or her parents' return.

Under prior law, controversies arose between taxpayers and the Internal Revenue Service over whether a particular stipend made in an educational setting constituted a scholarship or compensation for services. In particular, numerous court cases have involved resident physicians and graduate teaching fellows who have sought—often notwithstanding substantial case authority to the contrary—to exclude from income payments received for caring for hospitalized patients, for teaching undergraduate college students, or for doing research which inures to the benefit of the grantor.[20] The limitation on the section 117 exclusion made by the Act, and the repeal of the special rule relating to degree candidates who must perform services as a condition of receiving a degree, should lessen these problems of complexity, uncertainty of tax treatment, and controversy.

The Congress concluded that the section 117 exclusion should not apply to amounts representing payment for teaching, research, or other services by a student, whether or not required as a condition for receiving a scholarship or tuition reduction, and that this result should apply whether the compensation takes the form of cash, which the student can use to pay tuition, or of a tuition reduction, pursuant to which there is no exchange of cash for payment of tuition. Thus, where cash stipends received by a student who performs services would not be excludable under the Act as a scholarship even if the stipend is used to pay tuition, the Congress believed that the exclusion should not become available merely because the compensation takes the form of a tuition reduction otherwise qualifying under section 117(d). The Congress concluded, consistently with the overall objectives of the Act, that principles of fairness require that all compensation should be given the same tax treatment; that is, some individuals (e.g., students who perform teaching services for universities) should not receive more favorable tax treatment of their compensation than all other individuals who earn wages.

The Congress concluded that it was inappropriate under prior law for recipients of certain Federal grants who were required to perform future services as Federal employees to obtain special tax treatment which was not available to recipients of other types of grants who were required to perform services as a condition of receiving the grants. Thus, under the Act, the general exclusion rule and the limitations apply equally to all grant recipients.

Explanation of Provisions

In general

Degree candidates.—In the case of a scholarship or fellowship grant received by a degree candidate, an exclusion under section 117 is available only to the extent the individual establishes that, in accordance with the conditions of the grant, the grant was used for (1) tuition and fees required for enrollment or attendance of the student at an educational institution (within the meaning of sec. 170(b)(1)(A)(ii)), and (2) fees, books, supplies, and equipment required for courses of instruction at the educational institution ("course-related expenses").[21] This rule applies to all types of scholarship or fellowship grants, whether funded by a governmental agency, college or university, charitable organization, business, or other source, and whether designated as a scholarship or by some other name (e.g., "allowance").

[20] As the U.S. Tax Court stated in one case: "Interns and residents have been flooding the courts for years seeking to have their remuneration declared a 'fellowship grant' and hence partially excludable from income. They have advanced such illuminating arguments as they could have earned more elsewhere and they were enjoying a learning experience so therefore what they did receive must have been a grant. They have been almost universally unsuccessful and deservedly so. Why the amounts received by a young doctor just out of school should be treated differently from the amounts received by a young lawyer, engineer, or business school graduate has never been made clear." (*Zonkerman v. Comm'r*, 36 T.C.M. 6, 9 (1977), aff'd (4th Cir. 1978))

[21] Two Code provisions applicable to private foundations contain references to scholarship or fellowship grants "subject to the provisions of section 117(a)" (secs. 4941(d)(2)(G)(ii); 4945(g)(1)). The amendments made by the Act to the section 117 exclusion are not intended to treat scholarship or fellowship grants by a private foundation that would not have triggered section 4941 or 4945 excise taxes under prior law as self-dealing acts or taxable expenditures merely because such grants exceed the amount excludable by degree candidates under section 117 as amended by the Act or are made to nondegree candidates (up to the amount excludable under prior law). A technical amendment may be needed so that the statute reflects this intent.

The exclusion available under the Act for degree candidates is not limited to a scholarship or fellowship grant that by its express terms is required to be used for tuition or course-related expenses. Also, there is no requirement that the student be able to trace the dollars paid for tuition or course-related expenses to the same dollars that previously had been deposited in his or her checking account, for example, from a scholarship grant check. Instead, the amount of an otherwise qualified grant awarded to a degree candidate is excludable (after taking into account the amount of any other grant or grants awarded to the individual that also are eligible for exclusion) up to the aggregate amount incurred by the candidate for tuition and course-related expenses during the period to which the grant applies; any excess amount of the grant is includible in income. No amount of a grant is excludable if the terms of the grant earmark or designate its use for purposes other than tuition or course-related expenses (such as for room or board, or "meal allowances") or specify that the grant cannot be used for tuition or course-related expenses, even if the amount of such grant is less than the amount payable by the student for tuition or course-related expenses.

For purposes of the section 117 exclusion as modified by the Act, the term candidate for a degree means (1) a student who receives a scholarship for study at a primary or secondary school, (2) an undergraduate or graduate student at a college or university who is pursuing studies or conducting research to meet the requirements for an academic or professional degree, and (3) a student (whether full-time or part-time) who receives a scholarship for study at an educational institution (described in sec. 170(b)(1)(A)(ii)) that (1) provides an educational program that is acceptable for full credit toward a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation, and (2) is authorized under Federal or State law to provide such a program and is accredited by a nationally recognized accreditation agency.

Nondegree candidates.—The Act repeals the limited prior-law exclusion under section 117 for grants received by nondegree candidates. Thus, no amount of a scholarship or fellowship grant received by an individual who is not a degree candidate is excludable under section 117, whether or not such amount is used for or is less than the recipient's tuition and course-related expenses. This provision does not affect whether the exclusion under section 127 for certain educational assistance benefits may apply to employer-provided educational assistance to nondegree candidates if the requirements of that section are met (see sec. 1162 of the Act, extending the exclusion under Code sec. 127), or whether unreimbursed educational expenses of some nondegree candidates may be allowable to itemizers as trade or business expenses if the requirements of section 162 are met.

Performance of services

The Act repeals the special rule of prior law under which scholarship or fellowship grants received by degree candidates that represented payment for services nonetheless were deemed excludable from income provided that all candidates for the particular degree were required to perform such services. The Act expressly includes in gross income any portion of amounts received as a scholarship or fellowship grant that represent payment for teaching, research, or other services required as a condition of receiving the grant (Code sec. 117(c)).

To prevent circumvention of the rule set forth in section 117(c), that rule is intended to apply not only to cash amounts received, but also to amounts (representing payment for services) by which the tuition of the person who performs services is reduced, whether or not pursuant to a tuition reduction plan described in Code section 117(d). The Act therefore explicitly provides that neither the section 117(a) exclusion nor the section 117(d) exclusion applies to any portion of the amount received that represents payment for teaching, research, or other services by the student required as a condition of receiving the scholarship or tuition reduction. If an amount representing reasonable compensation (whether paid in cash or as tuition reduction) for services performed by an employee is included in the employee's gross income and wages, then any additional amount of scholarship award or tuition reduction remains eligible for the section 117 exclusion as modified by the Act.

As noted, employees who perform required services for which they include in income reasonable compensation continue to be eligible to exclude amounts of tuition reduction. In addition, section 1162 of the Act extends the availability of the tuition reduction exclusion for certain graduate students an additional two taxable years beyond its previously scheduled expiration for taxable years beginning after December 31, 1985, as part of the extension of Code section 127 under the Act.

The Act also repeals the special rule under prior law that permitted the exclusion of certain Federal grants as scholarships or fellowship grants, even though the recipient was required to perform future services as a Federal employee. Thus, any portion of a Federal scholarship or fellowship grant that represents payment for past, present, or future services required to be performed as a condition of the grant is includible in gross income. As a result, services performed as a Federal employee are not entitled to more favorable tax treatment than services performed for other employers.

Treatment of nonexcludable amounts

Under the Act, a child eligible to be claimed as a dependent on the return of his or her parents may use the standard deduction only to offset the greater of $500 or earned income (see I.A.3., above). Only for purposes of that rule, any amount of a noncompensatory scholarship or fellowship grant that is includible in gross income as a result of the amendments to section 117 made by the Act (including the repeal of any sec. 117 exclusion for nondegree candidates) constitutes earned income. [11]

[11] Amounts received as payment for teaching or other services also constitute earned income.

Compliance with new rules

Under the Act, the IRS is not required to exercise its authority to require information reporting by grantors of scholarship or fellowship grants to the grant recipients or the IRS, even though some amounts of such grants may be includible in gross income under section 117(a) as amended by the Act. (Of course, any amount of a grant that constitutes payment for services described in sec. 117(c) is subject to income tax withholding, employment taxes, and reporting requirements applicable to other forms of compensation paid by the payor organization.) The Congress anticipated that the IRS will carefully monitor the extent of compliance by grant recipients with the new rules and will provide for appropriate information reporting if necessary to accomplish compliance.

Effective Date

The modifications made by the provision are effective for taxable years beginning on or after January 1, 1987, except that prior law continues to apply to any scholarship or fellowship granted before August 17, 1986.[23] Under this rule, in the case of a scholarship or fellowship granted after August 16, 1986 and before January 1, 1987, any amount of such scholarship or fellowship grant that is received prior to January 1, 1987 and that is attributable to expenditures incurred prior to January 1, 1987 is subject to the provisions of section 117 as in effect prior to the amendments made by the Act.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $8 million in 1987, $64 million in 1988, $130 million in 1989, $160 million in 1990, and $164 million in 1991.

[23] For this purpose, a scholarship or fellowship is to be treated as granted before August 17, 1986 to the extent that the grantor made a firm commitment, in the notice of award made before that date, to provide the recipient with a fixed cash amount or a readily determinable amount. If the scholarship or fellowship is granted for a period exceeding one academic period (e.g., if the grant is made for three semesters), amounts received in subsequent academic periods are to be treated as granted before August 17, 1986 only if (1) the amount awarded for the first academic period is described in the original notice of award as a fixed cash amount or readily determinable amount, (2) the original notice of award contains a firm commitment by the grantor to provide the scholarship or fellowship amount for more than one academic period, and (3) the recipient is not required to reapply to the grantor in order to receive the scholarship or fellowship grant in future academic periods. A requirement that the recipient must file periodic financial statements to show continuing financial need does not constitute a requirement to reapply for the grant.

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